BEFORE THE NEBRASKA PUBLIC SERVICE COMMISSION

In the Matter of the Nebraska Public Service Commission, on its own motion, to make adjustments to the universal service fund mechanism established in NUSF-26	**Application No. NUSF-50 Progression Order No. 1**

QWEST CORPORATION'S INITIAL COMMENTS TO PROGRESSION ORDER NO. 1

Qwest Corporation ("Qwest") submits its initial comments to Progression Order No. 1 entered January 18, 2006 (*"Progression Order No.1"*) as follows:

1. Further Reducing Distributions Can Disproportionately Harm Qwest.

Docket NUSF-26 effected a drastic reduction to Qwest's NUSF distributions compared to the distribution scheme set up in Docket C-1628. Most ETCs reduced their access rates in connection with Docket C-1628, but Qwest is the only carrier whose NUSF-26 distributions did not make up for its access reductions. No other carrier faces the reductions Qwest already faces as a result of NUSF-26, and most carriers' distributions actually have increased. Moreover, no other carriers face the loss of support through porting to competitive providers that Qwest faces. Qwest bore the brunt of the transition from C-1628 to NUSF-26, and further reductions would disproportionately harm Qwest.

The transition mechanisms set up in Docket NUSF-26 to temporarily slow the rate of Qwest's NUSF distribution loss – including an over-earning redistribution

("OER") and a per-line backstop of $5.00 per line, per month – offer only limited and temporary protection from the massive support reductions ordered in Docket NUSF-26. The effectiveness of even these limited protections is offset by the Commission's decision to maintain most of the porting of NUSF-support to CLECs, even for in-town customers for which Qwest now receives no support. This increases unfavorably the impact of the reductions to Qwest's distributions as the OER and backstop protections phase out. In addition, the Commission agreed to provide Qwest with specific, targeted support in Docket NUSF-7, but in order to obtain those distributions, Qwest must make specified, directed investments in certain technologies in specific areas – investments that would not otherwise be required for NUSF-26 support and were not required for C-1628 support.

These changes could easily yield post-porting distributions to Qwest for high-cost support in 2007 of $10 million or less, compared to nearly $30 million in 2004. Without rationalizing the NUSF system, further reducing Qwest's support will only exacerbate the inequities Qwest faces, and will undermine Qwest's ability to maintain and improve its services in rural Nebraska, much more so than any other Nebraska carrier.

Rationalizing the NUSF system needs to be done on a coordinated basis. Currently, there are four key dockets pending, any one of which could drastically affect the way NUSF support is distributed: three different subdockets in NUSF-50,[1] and Docket C-3554. All of these dockets are interrelated, because all fundamentally address the basis for NUSF distributions. The decision on these dockets, therefore,

[1] NUSF-50, NUSF-50 Progression Order No. 1, and NUSF-50 Progression Order No. 2.

must be interrelated, and the Commission's decision process in any one docket should take all four dockets into account. Deciding one of these dockets without properly taking into account the factors that drive the other three could create further inefficiencies and inequities in the NUSF.

With respect to this specific docket, all of the proposed solutions must be coordinated as well. Adopting one proposal may render one or more others unnecessary. Thus, for each proposal or question raised by *Progression Order No.1*, Qwest's comments assume that proposal is the only one that would be adopted. With respect to the first question raised, if reductions to distributions must be made (and Qwest takes no position as to whether such reductions are the best course of action), those reductions must first be made so that the level of support and revenue carriers received under the resulting distribution system approaches those set up in Docket C-1628. Such a system would avoid further penalizing carriers that reduced access rates with the promise of revenue neutrality. After all carriers have been reduced to C-1628 levels of support, then all carriers should face equal, pro rata reductions down to the desired level of support.

2. *The Commission Should Reduce the Rate of Return for Carriers as a First Choice.*

In view of the increased strain on fund resources that will result from a lower surcharge, the Commission could adjust the 12% ceiling and therefore the resulting NUSF distributions. This will ensure that the support is distributed to the carriers that economically need it the most. Undoubtedly, the strain will increase if the Commission adds wireless support to the Fund's goals. Such an approach should be distinct from traditional ratemaking, which would determine fair and reasonable earnings and an appropriate rate of return for various carriers. Given the Commission's decision to lower the surcharge, however, the Commission should consider the pragmatic question of what level of return the current fund can ***afford*** to provide. If the current fund cannot afford to guarantee carriers twelve percent earnings, perhaps the Commission should look to a lower earnings level to support – and require carriers seeking higher rates of return to become more efficient and obtain more revenue from sources other than universal service funds.

Both federal and state USF statutes call for the NUSF to be "sufficient." In previous iterations of the Commission's approach to NUSF, the Commission has determined that "sufficient" means "no more than a 12% return," because the Commission presently reduces support so no carrier is earning a rate of return higher than 12%. Qwest is not aware, however, of any evidence or reasoning behind the Commission's decision to choose 12% as opposed to some other number for determining the maximum level of profits NUSF distributions should support.

Certainly, as a practical matter, when a carrier's rate of return decreases, so does the carriers' abilities and incentives to maintain and improve high cost services. This reality makes the Commission's choice difficult, but perhaps necessary in light of reduced resources. While in today's competitive environment a lower rate of return such as 10% percent may or may not be sufficient to guarantee the long-term health of a telecommunications company, the current mechanism does worse. Some ILECs may recover less than the Commission's rate of return cap relative to supported services, and the alternatives being considered will reduce that margin even more. Meanwhile, some other carriers may enjoy a twelve percent rate of return subsidized by urban ratepayers, even though they are no more efficient than the lower earning ILECs. Accordingly, Qwest proposes that the Commission's first choice should be to reduce the rate of return threshold for all carriers, and to extend the OER program indefinitely.

3. The Commission Does Not Need to Change The Way Earnings Are Calculated.

The Commission provided some flexibility to carriers in the January 13, 1999 order in Docket C-1628. Carriers can elect to use a three year rolling average for rate of return, and also may elect to provide earnings on a supported services basis. Qwest has chosen both of these options. The three year rolling average smoothes the financial results so there are less peaks and valleys and this results in a more predictable result over time. Focusing the results on supported services removes the impact of competitive and unregulated services. Traditionally, earnings is defined as operating revenue less operating expense less operating taxes where these components and investment are defined in the FCC's Uniform System of Accounts (47 C.F.R. Part 32). Qwest strongly supports following this traditional basis of regulatory accounting for the NUSF-EARN form. The current earnings test provides a consistent, comparable, and efficient method to state the financial results for each LEC receiving NUSF.

Qwest does not propose any modifications. However, if any modifications are made, the Commission should consider the source of a particular carrier's revenue in calculating earnings. Any method of calculating earnings should consider the level of local service charges to end users and switched access service charges to interexchange carriers for providing service to rural high cost consumers.

4. *The Commission's Proposed Method To Adjust Support to Carriers Consistently Exceeding The Rate of Return Caps Is Reasonable.*

The Commission sets forth a good method in paragraph 7 of *Progression Order No.1* for ensuring that carriers are not receiving support that drives earnings above the Commission's rate of return cap. It is Qwest's understanding that if, in the reporting year, a carrier exceeds the rate of return cap, and the calculation includes the reduction for the excess amount from the previous reporting year, the NUSF support adjustment should be equal to the amount by which the carrier exceeds the rate of return cap in the current reporting year in addition to the previous adjustment.[2] In other words, assuming a twelve percent cap, if a carrier earned fifteen percent in year 1, then support would be reduced by the 3% excess in year 2. Additionally, if earnings in year 2 were actually again above the 12% earnings cap, for example at 14% or above the cap by the 2% excess, then in year 3 the earnings adjustment would be the sum of the two years' excess, or the support associated with the 5%excess. Such a system trues up the prior years excess and will even out the carriers' support over time to be equal to or below the rate of return cap. Providing support to other carriers that are below the Commission's cap will economically encourage more investment in supported services.

5. *Qwest Reserves Its Position On Raising The Local Rate Benchmark to $18.50.*

Qwest presently takes no position on raising the benchmark, but reserves the right to respond to other parties' comments and testimony on this issue.

[2] In 2006, the current reporting year on the NUSF-EARN form is calendar year 2005.

6. *The Commission Should Keep Transitional Support Mechanisms In Place.*

As mentioned above, potentially Qwest faces tremendous decreases in its NUSF distributions over the transition period set up in NUSF-26. If the transition mechanisms were ended now, Qwest would end up with less than $4,000,000 in NUSF support after more than $10,000,000 is ported to CLECs. That would represent a near catastrophe for Qwest. Indeed, the Commission recognized this in its final ruling on NUSF-26 just over a year ago when it set up the transition mechanisms. If Qwest's NUSF distributions are reduced so drastically, Qwest may have to begin questioning whether the increased regulatory burdens of the NUSF outweigh the benefits received through NUSF distributions. Thus, as outlined above, Qwest proposes that the OER be extended indefinitely, with a reduced rate of return cap, to avoid penalizing lower earning carriers with more shortfalls than they are already experiencing. As carriers apply the built-in economic incentives to invest created by the NUSF-26 structure, the OER should all but evaporate fairly quickly. Thus, extending the OER indefinitely is not likely to have significant effect over the long term, unless over-earning carriers continue to fail to invest in their networks.

7. *Access Reductions Must Be Revenue-Neutral; Thus, As NUSF Distributions Are Decreased, The Commission Must Allow Carriers to Return Access Rates To A Revenue-Neutral Rate.*

Qwest commented extensively on this issue in connection with the investigation into its recent increases in switched access rates in Docket C-3345/NUSF-42. Qwest incorporates those comments here, and will not repeat them at length. However, some brief comments are in order. First, Qwest's advocacy, and the Commission's approach to access reduction in Docket C-1628 were based on revenue neutrality. That is, carriers reduced their access rates, but received NUSF funds to make up for the lost revenue. That approach was unchanged in Docket NUSF-26, which did not directly address access rates. NUSF-26, however, did impact Qwest and some other carriers by reducing their NUSF high-cost distributions in spite of the fact that those reductions resulted in prior access rate reductions losing their revenue-neutral character.

Accordingly, to carry through the revenue neutrality policies behind C-1628, it is critical for carriers that lose support to be able to adjust their access rates to a revenue-neutral rate. Qwest proposes that ETCs that experience losses in NUSF-26 distributions compared to C-1628 distributions, and wish to return their rates to a revenue-neutral rate, notify the Commission of their intention to do so thirty days before any such rate would become effective.

The notice to the Commission should include (1) an explanation of the rates previously charged, the history of rate changes in response to Docket C-1628, (2) the NUSF distributions the carrier has received through NUSF-26 in the prior year, and reasonably expects to receive over the next year, (3) access demand for the prior year, and (4) projected access revenue as a result of the access rate increase during the year following the application, based on the access demand reported in item (3). The calculation of revenue neutrality should not take into consideration any NUSF or federal USF revenue other than distributions through the NUSF-26 mechanism. Thus, for example, Lifeline, Linkup, federal access support, federal high cost support, and distributions through specifically targeted NUSF-7 orders would not be included in the revenue neutrality calculation. Of course, such procedures should be limited to situations where carriers are seeking to increase switched access rates in response to NUSF-26 distribution reductions.

8. *Any Modifications to NUSF Distributions Must Be Carefully Coordinated With Other Dockets and Phased In Over A Reasonable Period Of Time.*

As noted above, it is absolutely critical that the Commission avoid a piecemeal decision process with respect to the four pending dockets tied to NUSF high-cost distributions. The Commission must take the time necessary with each docket to make sure the result in each docket supports the policies driving the results in the other dockets. Beyond those considerations, the Commission must take care that any changes to the current system do not create sudden and drastic changes to the market or for individual carriers. At this point, it is impossible to define the precise contours of any specific proposal sufficiently to define an appropriate phase-in period, but the Commission should use any existing surplus in the fund to its maximum extent to avoid any disruptions.

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Respectfully submitted,

QWEST CORPORATION

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